

# Why the Kremlin Won't Privatize Rosneft

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After World War II, French governments from both sides of the political aisle pursued a policy known as dirigisme. Dirigisme entailed consolidating fragmented industrial assets into large holdings, or "national champions," that could carry long-term economic growth and speed up recovery in the postwar years. National champions to this day remain enshrined in the national conscience of the French people as proud symbols of French wealth, a family silver of sort. Selling the family silver usually doesn't make for a popular policy.

Dirigisme has reemerged as a buzzword in global policy after the first coronation of Vladimir Putin as Russian president. Already in his 1997 dissertation, Putin outlined a dirigiste idea of using raw materials as the basis for Russia's return on the economic superpower scene, led by closely regulated national champions. He also emphasized foreign investment as a strategic goal in the development of national champions. Unlike most political leaders, Putin stayed true to his early ideas.

Rosneft's acquisition of TNK-BP was possibly the most widely covered business deal this year. Yet, it was primarily important for all the secondary reasons many commentaries cited. When

combined with several large yet relatively under-reported Rosneft moves, it provides grounds for an ambitious claim.

In January, James Henderson of the Oxford Institute for Energy Studies published what he considered to be five crucial steps for Rosneft to become a competitive global National Oil Company (NOC) modeled after national champions like PetroChina or Petrobras. In his opinion, these are the five steps to NOC status: improving technical expertise, diversifying international assets, partnership with an International Oil Company (IOC), diversification into the gas business and improved transparency and corporate governance. In just under a month, President Putin and his close ally and Rosneft's CEO Igor Sechin fulfilled all five steps. This points to Rosneft's new role as the central axis of Putin's energy policy, a place it took from longtime star Gazprom. With this new role, I believe Rosneft's privatization just went off the table.

So why did the TNK-BP deal matter? Yes, because of its sheer size. Absorbing TNK-BP will raise Rosneft's crude production to around 4.6 million barrels a day, placing it above any Middle Eastern country's production except Saudi Arabia and making it the world's largest listed oil company, producing over 40 percent of Russia's oil. But Rosneft's production before the acquisition was already matching that of PetroChina and Petrobras. The acquisition mattered more for Rosneft's long-term development plans, and this is where Henderson's five steps come into play.

The first step on the road to acquiring global NOC status is technical expertise. Rosneft lacked this, and BP has plenty to spare. This is why BP entered into Rosneft's ownership structure with an unprecedented stake of almost 20 percent. The bulge in Rosneft's production is derived from young Siberian oil fields around Yugansk, expropriated from the Yukos oil company. However, aging technology in Yugansk is rapidly raising production costs with every passing year, pushing potent fields toward scarce profitability. BP can offer much-needed better technology to optimize these fields. BP's technology in TNK-BP's Samotlor Siberian field improved oil-recovery rates and raised output by 40 percent above its 1990s low, according to TNK-BP's website. Another long-term strategic asset of Rosneft is the untapped oil deposits in the Arctic Shelf, estimated by Rosneft to be around 200 billion barrels. Lacking technology for these fields, Rosneft signed agreements to explore the Arctic with Exxon, Eni and Statoil, but with BP's strategic partnership Rosneft will have an "in-house" expert on developing offshore oil deposits. A recent talent acquisition in offshore drilling from Exxon affirms Rosneft's intention to focus on developing the internal technical expertise necessary to develop its promising long-term projects.

The second step for Rosneft to become a global NOC was international diversification. With TNK-BP's purchase, it has done well. TNK-BP has subsidiaries in Ukraine, Venezuela, Vietnam and Brazil. With Rosneft's operations in Germany and North America, this makes for a solid global network. Yet, Rosneft's leadership is making sure to use every opportunity that presents itself. Recently, Surgutneftgaz raised the possibility of exiting the National Oil Consortium, an association of Russia's five largest oil producers that own 40 percent of the Junin-6 oil field project in Venezuela together with Petroleos de Venezuela. The other four Russian partners are Rosneft, Gazpromneft, LUKoil and TNK-BP. With Rosneft's acquisition of TNK-BP and the potential purchase of Surgutneftgaz's stake in the project, Rosneft would consolidate its stake in the Consortium at 60 percent, taking over as the major

Russian partner and reinforcing its position in South America.

With the increase of BP's ownership stake, Rosneft also fulfilled the third step necessary for developing as a national energy champion — the involvement of an International Oil Company (IOC), one of the global oil "supermajors." With BP's strategic partnership, Rosneft will develop operating experience in foreign ventures and approach international expansion with less friction. BP's investment potential is largely untapped at the moment so potential for joint ventures with BP beyond Russia will probably come up as a possibility. The partnership will allow it to gain more operational experience, tap more financing sources and combined with domestic production capacities, further help Rosneft's international expansion and growth.

The fourth step in Rosneft's bid for the place of leading Russian energy champion was substantial diversification into the gas business. Rosneft's current gas production stands at a modest 2 percent of Russia's total. On Nov. 1, Inter RAO, a state-owned electricity company, announced that Rosneft had won over a 25-year \$80 billion gas supply deal from Novatek, an independent gas producer. A major stakeholder in Novatek is Gennady Timchenko, a close ally of Putin's circle whose commodity trading giant Gunvor sells a significant portion of Rosneft's oil abroad. The Inter RAO supply deal Rosneft won from Novatek accounted for 30 percent of its sales, the Kommersant newspaper reported. All of this points to a serious focus of Rosneft's leadership to substantially diversify its business into gas holdings, even at a substantial cost to a friend — Novatek's shares fell 6.9 percent that day. It has been rumored that Rosneft is also considering an outright purchase of Inter RAO, and Sechin confirmed that Rosneft was still looking at buying a stake in Inter RAO in an effort to consolidate the company's energy assets in Russia.

The final step that will reinforce Rosneft's newly acquired status as a national energy champion will be increasing transparency and establishing good corporate governance. Allowing BP to acquire a 5.66 percent stake in addition to its 12.84 percent stake in Rosneft brought its share up to 19.75 percent, making BP Rosneft's second-largest shareholder after the state. Various estimates predict that BP will be allowed to appoint between 1 and 2 board members on Rosneft's nine-seat board. Sechin commented on the agreement in a recent investor briefing by saying that "BP's experience and effectiveness demonstrated in TNK-BP will allow us to also strengthen Rosneft." Before the acquisition was made, a process expected to finish in early 2013, the Russian government owned 75 percent plus one share in Rosneft that enabled it to have the final say on all strategic matters. With BP in its structure, Rosneft's board will be forced to work harder toward a greater degree of transparency and efficiency through compromise. This might prove an ambitious challenge for its current management, which grew Rosneft to its current size with less of a consensus-focused decision-making style. Still, it made the decision to involve BP to such a great measure so its preparedness for change must be substantial.

Fulfilling all these five steps, some of which Rosneft already completed or initiated, will reaffirm its decisiveness to build itself into a leading national oil company and the premier Russian energy champion.

This extraordinary confluence of events around Rosneft in such a short time period leads me to believe that privatization will not be an option in the foreseeable future. It would not make

sense. Market responses to the TNK-BP deal have been diverse. While many investors see potential, warnings from Fitch about Rosneft's credit metrics raise questions. The rating agency estimated that Rosneft's present capital structure could absorb a maximum of \$15 billion of additional debt without losing its current rating level, an insufficient amount for the total acquisition of 100 percent of TNK-BP. Those that think privatization will still follow might point to this as a reason for BP's increased stake in Rosneft. However, several other events indicate that the Kremlin's plans for Rosneft do not include any sweeping privatization moves.

In October, Putin ordered that 75 percent of all licenses to explore Russia's oil deposits should be transferred to Rosneft as soon as possible. It is unlikely that Rosneft will go through a substantial privatization process while it is considering new asset purchases. First Deputy Prime Minister Igor Shuvalov's statements on the topic summarize this best, while remaining dedicated to market reform and privatization plans, Rosneft's case will be a more delicate one because of its increasing importance as an energy sector leader. Having fulfilled all the necessary steps to become a leading global NOC, Rosneft is taking over the role of the Kremlin's new political and economic national champion.

But Putin should beware. As Gazprom, Kremlin's darling-turned-potential liability, faces modernization issues, falling gas prices, competition and on top, an EU probe, Putin and his political strategists will soon turn to Rosneft for their usual power exercise in energy politics. However, Rosneft is still primarily an oil-driven company. And as Konstantin Simonov, president of Russia's National Energy Security Foundation told Bloomberg, oil is a buyer's market driven much more by traders than producers, unlike the monopolized gas market where political influence can be substantially easier to exert. Thus, another possible strategy arises. In 2004, Putin attempted to unite Rosneft and Gazprom in a single national energy champion that would dominate both gas and oil sectors, but the deal fell apart as Rosneft openly disagreed with the takeover's terms. With Gazprom's stagnating output and slow reform, Rosneft might soon be the driver of another consolidation move that would create a new Russian energy empire of gargantuan proportions.

Currently studying history and economics at Harvard, Luka Oreskovic is the co-founder of the Strategic Asset Stewardship Initiative, which focuses on global trends in privatization, nationalization and economic reform.

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